No. 22,227

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

HULET P. SMITH and LOMA M. SMITH,

Respondents

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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OPINION BELOW

The memorandum opinion of the Tax Court (R. 20-25) is not officially reported.

JURISDICTION

This petition for review (R. 27-29) involves federal income taxes for the taxable years 1962 and 1963. On September 27, 1965, the Commissioner of Internal Revenue mailed to the taxpayers a notice asserting deficiencies in those taxes in the aggregate amount of \$1,577.54. (R. 6.) Within 90 days thereafter, on November 22, 1965, the taxpayers filed a petition with the Tax Court for a redetermination of those deficiencies under the provisions of Section 6213 of

the Internal Revenue Code of 1954 and for a determination that the taxpayers had overpaid their taxes for those years. (R. 1-12.) The decision of the Tax Court was entered on April 11, 1967. (R. 26.) The case was brought to this Court by a petition for review filed on July 5, 1967 (R. 27-30), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of the Code.

QUESTION PRESENTED

Can homeowners deduct depreciation and maintenance expenses on their house simply because they offer it for sale, move out of it, and into a new house?

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations are set out in the Appendix, *infra*.

STATEMENT

The relevant facts, all of which were stipulated (R. 16-19, 21-24), are as follows:

The taxpayers are husband and wife and resided in Pebble Beach, California, during 1962 and 1963, the taxable years involved. For approximately twenty years the taxpayers lived in Arcadia, California. The fair market value of their home in December, 1961, was $80,000, which was somewhat less than its cost basis. (R. 16, 21.)

In 1959, the husband decided to retire from business and move to Pebble Beach, California, a distance of some 400 miles. They purchased land at Pebble Beach and built a substantially larger and more expensive home than their home in Arcadia. (R. 17, 22.)

In the early spring or summer of 1961, the taxpayers offered their home in Arcadia for sale and made continuous efforts to sell that property until the spring of 1964, when it was finally sold for $62,500. In December of 1961, the taxpayers moved from their old home in Arcadia into their new home at Pebble Beach. They did not intend to return to their former Arcadia home and, in fact, they never thereafter re-occupied their former home. (R. 17, 18, 22, 23.)

Upon moving to Pebble Beach, the taxpayers took with them most of the furniture and furnishings of their Arcadia house, including some of the permanent floor carpeting, leaving only the window drapes and part of the floor carpeting. Also, the taxpayers removed a truckload of plants and flowers from the Arcadia property which were installed at their new house. (R. 17, 22-23.)

The taxpayers decided not to retain the property for investment purposes. The anticipated rental would not justify it. Moreover, to rent the house would have prevented the taxpayers from getting their money out of the property quickly by sale. A two or three years lease would have been necessary to induce a tenant to incur the necessary expenditures to make the house habitable, and it would have been difficult to show the property to prospective purchasers during that period. Because of those considerations, the taxpayers did not offer their house for rent. (R. 18, 23.)

The amounts spent by the taxpayers to maintain and repair their old house during 1962 and 1963 ($2,744.21 and $2,640.40) were reasonable and necessary to maintain the property for sale. (R. 18,

23-24.) As of December 31, 1961, their old house had a cost basis of $60,940 and an estimated life of 25 years. (R. 18-19, 24.)

The Tax Court held (R. 25) that during the taxable years the taxpayers held their old house for the production of income within the meaning of Sections 167(a)(2) and 212(2) of the Internal Revenue Code of 1954 and, accordingly, allowed the taxpayers to deduct depreciation and maintenance expenses incurred on that property during those years.[1/]

SPECIFICATION OF ERRORS RELIED UPON

1. The Tax Court erred in holding that the taxpayers' house was property held for the production of income rather than a personal asset.

2. The Tax Court erred in holding that the taxpayers could deduct maintenance and repair expenses on their house under Section 212 (1) during the years at issue.

3. The Tax Court erred in holding that the taxpayers could deduct depreciation on their house under Section 167(a)(2) during the years at issue.

4. The Tax Court erred in entering its decision for the taxpayers.

1/ Taxpayers had listed deductions for the maintenance and repair expenses, but no deductions for depreciation, on their income tax returns. The depreciation deductions were first claimed in their protests of the Commissioner's initial assertion of proposed deficiencies in taxes. (See R. 2, 8.)

SUMMARY OF ARGUMENT

1. The homeowners in this case offered their house for sale while they still resided there. Several months later, their new house, which they had constructed for them, was ready for occupancy. Although the taxpayers had not yet succeeded in selling their old house, they moved into their new house and continued to offer the old house for sale until, at a later date, it was finally sold. These facts do not support treating these taxpayers any differently from a tax standpoint than the typical homeowner who, in the process of changing residences, attempts to sell his old house. That common transaction--the sale of a house by a homeowner--is a personal transaction in connection with which the homeowner can deduct neither expenses, depreciation, nor losses.

The issue in this case is whether these homeowners held their house as investment property rather than as a personal asset. The mere holding of the property only for sale did not convert it from a personal asset to one held for the production of income, for the house was held for sale only to complete a typical personal transaction of homeowners, namely, the changing of residences. In our society, in which the average homeowner may expect to live in several houses during his lifetime, the personal activity of owning a home often includes the eventual sale of one, and the purchase of another, residence.

Here, the taxpayers were not attempting to convert the house into investment property. Instead, like typical homeowners planning to move to a new residence, the taxpayers offered the house for sale

while still living in it. Thus, they were clearly attempting to sell it as a personal--as distinguished from a production-of-income--asset. When they moved into their new residence some months later and continued to offer their old house for sale, their motive had not changed. They continued to offer it for sale simply to effect a personal transaction, the changing of their residence.

Indeed, the evidence affirmatively precludes the existence of any motive to convert the property into investment property. After moving out of the house, the taxpayers did not offer it for rent because the anticipated return would not justify retaining the property for investment purposes. Moreover, the taxpayers did not attempt to convert the property into an attractive investment property in anticipation of a profitable sale. Instead, concerned primarily with changing their residence, they stripped the house and property of certain improvements, and expenditures would have had to be made by a prospective occupant to make the house habitable. Thus, moving out of the house and continuing to hold it for sale thereafter were not steps taken to convert it into investment property or to effect an investment transaction but were simply events that were necessary for the taxpayers to change their residence, a personal transaction.

Congress, recognizing the essentially personal nature of the type of transaction involved here and the frequency of its occurrence, often largely unavoidable, in our mobile society, has provided by statute that no gain shall be recognized upon the sale of

the old residence where the new residence is acquired within a year of the sale. The legislative history of that provision discloses that Congress was aware that the mere holding of a former residence for sale to carry out that type of transaction constituted a use of the property as a residence, in contradistinction to a use of the property for the production of income.

The Tax Court's memorandum opinion does not purport to explain why these homeowners should be treated differently from homeowners generally. Instead of discussing the personal nature of residential property and the question of conversion to an investment purpose, the Tax Court held that Mitchell v. Commissioner, 47 T.C. 120 (1967), involved the "identical issue" as the instant case. To the contrary, in Mitchell the question was whether depreciation deductions could be taken on an old hospital acquired and held, and eventually sold, only as investment property. It did not involve residential property or any other type of a personal asset.

2. Even if this Court holds that taxpayers' house was converted from a personal asset to an investment asset, we contend that the taxpayers are not entitled to depreciation deductions on that house. As is clear from the legislative history of the relevant statutory provision, depreciation deductions for investment property are subject to the same requirements and limitations, aside from the "trade or business" requirement, as are such deductions for business property. It is well settled that when business assets are not held for active use in the business but are held only for sale they are not depreciable. Because Congress intended that comparable treat-

ment be given investment assets, they too should not be depreciable if held only for sale. Moreover, the function of depreciation is to allow taxpayers to offset income generated by an asset with annual deductions reflecting the diminution in value of that asset resulting, at least in part, from its use in producing that income. An asset held solely for sale, on the other hand, generates no periodic income, and any decrease in its value is automatically reflected in the ultimate sales price, without need of depreciation deductions. Finally, allowing depreciation deductions on investment assets held solely for sale is inconsistent with the structure of the depreciation provisions. The difficulty of determining useful life during which taxpayers will hold an asset for sale, the absurdity of figuring salvage value (estimated sales price) which will ordinarily exceed the cost of the asset--these problems illustrate the inappropriateness of permitting depreciation deductions for an asset held only for sale.

ARGUMENT

I

HOMEOWNERS MAY NOT DEDUCT DEPRECIATION OR MAINTENANCE AND REPAIR EXPENSES ON THEIR HOUSE SIMPLY BECAUSE THEY OFFER IT FOR SALE, MOVE OUT OF IT AND INTO A NEW HOUSE

A. Introduction

Throughout the Code, the allowability of deductions (including those claimed here for maintenance, repairs, and depreciation) often depends on whether the activity that gives rise to the expense falls within one of three categories: business, investment, or personal. The determination of the category of a particular activity depends upon the origin and nature of the activity rather than on its consequences. United States v. Gilmore, 372 U.S. 39, 45, 47-48 (1963). The reason for these distinctions are clear. While personal activities and the disposition of personal assets may occasionally result in a profit or gain includible in gross income, more often than not they simply result, as in this case, in expenses and losses which, if allowed as deductions, would reduce income received from other sources. By contrast, deductions for business or investment (production of income) activities are allowed to assure that the tax is imposed on the net, rather than on the gross, income from the profit-motivated activities generating the expenses.

No asset fits more obviously in the personal category than one's own house. For this reason, the ordinary homeowner is not permitted to deduct expenses, depreciation, or loss in connection with his residence. To obtain such deductions, the homeowner must first convert

his home from personal to either business or investment use. In this case, the taxpayers offered their residence for sale while they still lived in it. When their new residence was completed, they moved into it and out of their old residence, which was finally sold some two years later. These actions, we shall show, do not transform a home from a personal to an investment asset so as to permit a homeowner who offers his house for sale in the usual process of changing residences more favorable tax treatment than that accorded the ordinary homeowner who moves from one house to another.

B. Taxpayers may not deduct depreciation or maintenance and repair expenses if incurred in connection with a personal asset or activity as opposed to a business or investment asset or activity

The pertinent provisions of Section 212 of the Internal Revenue Code of 1954 (Appendix, infra) allow a deduction for the "ordinary and necessary expenses" incurred "(2) for the management, conservation, or maintenance or property held for the production of income * * *." The depreciation provision, Section 167 (Appendix, infra), allows a similar deduction for the exhaustion, wear and tear "(2) of property held for the production of income." As the legislative history of these provisions makes clear, both are subject to the same limitations that apply to the deduction of business expenses and depreciation, which includes the bar contained in Section 262 (Appendix, infra) against the deduction of "personal, living, or family expenses."

Prior to the introduction of those provisions by the Revenue Act of 1942, the Supreme Court had made clear that expenses incurred in income-producing activities were not deductible unless the activity constituted a trade or business. In Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court held that a taxpayer could not deduct the expenses of managing his securities because that activity did not constitute a trade or business. See also City Bank Co. v. Helvering, 313 U.S. 121 (1941); United States v. Pyne, 313 U.S. 127 (1941). Congress responded to these decisions by enacting the predecessors of Sections 212 (1) and (2) and 167(a)(2). Revenue Act of 1942, c. 619, 56 Stat. 798. Those amendments were designed to eliminate the requirement that an investment or income-producing activity must rise to the level of a trade or business before ordinary expense or depreciation deductions would be allowable. On the other hand, those amendments were not designed to give more favorable tax treatment to investment activity than to business activity. The Committee Reports state that (H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 74-75 (1942-2 Cum. Bull. 372, 429-430); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87-88 (1942-2 Cum. Bull. 504, 570-571))--

> A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction * * * of an expense paid or incurred in carrying on any trade or business.

The relevant restriction or limitation that applies in this case is the bar against deducting personal expenses. Just as there is a personal-business distinction, so there is a personal-investment distinction, for as the Supreme Court held in United States v. Gilmore, 372 U.S. 39, "it is clear that the 'personal * * * or family expenses' restriction of [the predecessor to Section 262] must impose the same limitations upon the reach of [the predecessor to Section 212(1) and (2)]" as it imposes on the reach of Section 162. See also McDonald v. Commissioner, 323 U.S. 57, 62 (1944); Lykes v. United States, 343 U.S. 118, 121-123 (1952); Trust of Bingham v. Commissioner, 325 U.S. 365, 373-374 (1945); Lewis v. Commissioner, 253 F. 2d 821, 825 (C. A. 2d, 1958); Bowers v. Lumpkin, 140 F. 2d 927 (C. A. 4th, 1944), certiorari denied, 322 U.S. 755.

Sections 167(a)(2) and 212(1) and (2) then, are intended to grant deductions only as comprehensive as those granted to taxpayers engaged in trade or businesses by Sections 167(a)(1) and 162(a), for activities and investments dominated by the profit motive (see Hirsch v. Commissioner, 315 F. 2d 731, 736 (C. A. 9th, 1963)), even thoug the frequency and magnitude of such activities and investments are insufficient to constitute the carrying on of a trade or business. The legislative history of these provisions negates any suggestion that they were to obliterate the traditional distinction between profit-motivated activities, on the one hand, and personal transactions, including the disposal of personal assets, on the other hand. Indeed, as the legislative history and subsequent Supreme

Court interpretation of that history shows, Congress intended that there be a personal-investment distinction in Sections 212 (1) and (2) and 167(a)(2), just as there is a personal-business distinction in Sections 162(a) and 167(a)(1).

C. Taxpayers' attempt to sell their home was a personal transaction

The Tax Court mistakedly permitted the taxpayers to deduct the maintenance and repair expenses and depreciation on their old house for the years 1962 and 1963 on the basis that the Tax Court's recent decision for the taxpayer in Mitchell v. Commissioner, 47 T.C. 120 (1966) (R. 24) "involved the identical issue."[2/] In fact, we contend, Mitchell did not involve the identical issue, for the property involved in that case was not the taxpayer's residence but an old hospital which the taxpayer acquired and held only as investment property. In that case, the Tax Court was not required to focus on the distinction between personal and investment activities that is present in this case, for it held that (p. 126) "the evidence is clear and uncontroverted that the petitioner bought the property as an investment." Since the Tax Court was dealing with investment property rather than a personal asset, it was an easy matter to conclude that the holding of such property for sale satisfies the requirement that property be held for the production of income.

2/ The Tax Court also relied on Robinson v. Commissioner, 2 T.C. 305 (1943), on remand from 134 F. 2d 168 (C. A. 3d, 1943) and Briley v. United States, 189 F. Supp. 510, 513, 514 (N.D. Ohio, 1961), reversed on another issue, 298 F. 2d 161 (C. A. 6th, 1962). Because the properties in those cases were held for sale and rent, neither case is dispositive of the issue in this case.

Since this case involves a residence, which is a personal asset, rather than a hospital, which is normally a business or investment asset, Mitchell is not controlling. The issue in this case--whether the taxpayer's house was converted from a personal asset to a business or investment asset--was not even present in Mitchell.

In our view, the legal issue in this case is whether a former residence may be converted from a personal asset into a business or investment asset when a homeowner, who has offered his house for sale, moves out of that house and into his new residence while his former residence is still up for sale. We contend that a residence does not become an investment asset simply because the homeowner, in the process of moving to a new residence, offers his old residence for sale.

The taxpayers in this case, like most homeowners, bought their house for residential purposes. Such personal purposes may include the likelihood of eventual sale. Every homeowner may buy a house with the hope or expectation that its market value will increase over the years and bring him a profit when he sells the house and moves into another. But this expectation, common to all homeowners, does not convert a house from a personal asset into property held for the production of income, for it is well settled that the ordinary homeowner may not deduct maintenance and repair expenses and depreciation on his house from the moment he offers it for sale. When the Tax Court, in prior cases, focused on the nature of a former residence as a personal asset, it consistently held that the house is not converted to property held for the production of income simply because

the taxpayer offers it for sale; accordingly, the Tax Court denied deductions for maintenance expenses and depreciation. Melone v. Commissioner, 45 T.C. 501 (1966); Stutz v. Commissioner, decided June 24, 1965 (P-H Memo T.C., par. 65,166).3/ Neave v. Commissioner, 17 T.C. 1237, 1243 (1952); Coulter v. Commissioner, decided March 23, 1950 (P-H Memo T.C., par. 50,077); see Jones v. Commissioner, 22 T.C. 407, 414 (1954) (dictum), reversed on another issue, 222 F. 2d 891 (C. A. 7th, 1955); Horrmann v. Commissioner, 17 T.C. 903, 907-908 (1951) (dictum); cf. Fagan v. Commissioner, decided January 26, 1950 (P-H Memo T.C., par. 50,017); Newberry v. Commissioner, decided February 27, 1945 (P-H Memo T.C., par. 45,077).4/ See also Section 1.212-1(h) of Treasury Regulations on Income Tax (1954 Code), Appendix, infra.

3/ In the Stutz case, supra, amounts expended while the property was being held for rent were held deductible, but similar expenses incurred while the property was being held only for sale were held not to be deductible.

4/ In the Fagan case, supra, a depreciation deduction was allowed, and in the Newberry case, maintenance expense and depreciation deductions were allowed although the properties there involved were never held for rent, but only for sale. But, in Fagan, the Tax Court specifically found that (p. 35)--

> Neither the petitioner nor her husband ever occupied the Pebble Beach house as a residence and, in fact, never used it al all except for a few weekends * * * in 1930 and 1931, and on one occasion * * * [for ten days]

The house in question was built in 1929 and was offered continuously for sale from 1933 until it was finally sold in 1947. Under those limited circumstances, the Tax Court concluded that there had been a holding for long-term investment purpose.

(continued)

A similar analysis is made in related areas. Section 165(c)(2), for example, allows the deduction of losses incurred in "any transaction entered into for profit." 5/ Yet this Court, the Tax Court, and at least two other Courts of Appeals, have denied loss deductions to homeowners who abandon their residence and offer it only for sale on the basis that the mere holding of a former residence for sale, and the sale itself, does not constitute a conversion or appropriation of the property to income-producing purposes. Guffey v. United States, 339 F. 2d 759 (C. A. 9th, 1964); United States v. Kyle, 242 F. 2d 825 (C. A. 4th, 1957); Seletos v. Commissioner, 254 F. 2d 794 (C. A. 8th, 1958); Melone v. Commissioner, 45 T.C., pp. 505-506; Rogers v. Commissioner, decided January 18, 1965 (P-H Memo T.C., par. 65,008); Stutz v. Commissioner, supra; Horrmann v. Commissioner, supra; Grammer v. Commissioner, 12 T.C. 34 (1949); Leslie v. Commissioner, 6 T.C. 488, 493. 6/

4/ (continued)
Similarly, in Newberry, supra, p. 287, "The petitioners never used this property for residential purposes nor did they acquire it for such use. * * * they * * * have held it solely for investment."

The Fagan and Newberry cases, then, are distinguishable on their facts from the instant case for essentially the same reason as is Mitchell v. Commissioner, 47 T.C. 120 (1966), discussed supra, in the text (pp. 13-14).

5/ The legislative history of this loss provision parallels the legislative history of Sections 212 (1) and (2) and 167(a)(2). The first modern income tax act permitted the deduction of "necessary" (continued)

6/ Indeed, in some of the cases involving the question of the deductibility of a loss on the sale of a residence, it was held that no loss deduction was available, even though the property was offered, unsuccessfully, for rent while it was being offered for sale (see, e.g., (continued)

In another area, Congress considered whether holding a former residence for sale converts it into an investment asset. Section 1034 provides for the non-recognition of gain upon the sale of property used by the taxpayer as his principal residence to the extent that the sales proceeds are reinvested in another residence within one year before or after the sale date.[7/] Due to the coverage of that section, Congress was squarely faced with the question whether a home became property held for the production of income when it was offered for sale. The Committee Reports on the predecessor to Section 1034

5/ (continued)
business expenses and "losses actually sustained during the year incurred in trade"; expressly made not deductible were "personal, living, or family expenses". Income Tax Act of 1913, Section IIB, c. 16, 38 Stat. 114, 166, 167. That Act was soon interpreted not to permit the deduction of losses incurred in profit-motivated investment dealings which did not constitute an actual "trade" of the taxpayer. <u>Mente</u> v. <u>Eisner</u>, 266 Fed. 161 (C. A. 2d, 1920); T.D. 2090, dated October 14, 1914. And Congress responded by allowing the deduction of losses incurred in "any transaction entered into for profit." Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 5(a).

The prohibition contained in the Income Tax Act of 1913 against the deduction of personal expenses has been reiterated in every subsequent internal revenue statute. Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 5(a); Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 215(a); Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 215(a); Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 215(a)(1); Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 215(a)(1); Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 24(a)(1); Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 24(a)(1); Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 24(a)(1); Revenue Act of 1938, c. 289, 52 Stat. 477, Sec. 24(a)(1); Internal Revenue Code of 1939, Sec. 24(a)(1); Internal Revenue Code of 1954, Sec. 262.

6/ (continued)
the <u>Rogers</u>, <u>Horrmann</u>, <u>Stutz</u> and <u>Grammer</u> cases <u>supra</u>), whereas, an unsuccessful offer to rent has been considered to be a conversion of
(continued)

7/ Under the 1939 Code, the gain realized upon the sale of a personal residence, measured by the excess of the selling price over the
(continued)

answered that question in the negative by providing that (H. Rep. No. 586, p. 109 (1951-2 Cum. Bull., p. 436); S. Rep. No. 781 (Part 2), p. 32 (1951-2 Cum. Bull., p. 566)), "The term 'residence' is used in contradistinction to property used in the trade or business and property held for the production of income * * *."

6/ (continued)
the property to income-producing purposes for the purposes of the Section 212(2) deduction (Robinson v. Commissioner, 2 T.C. 305 (1943), on remand from 134 F. 2d 168 (C. A. 3d, 1943); Horrmann v. Commissioner, supra, Jones v. Commissioner, supra, Stutz v. Commissioner, supra; cf. Fagan v. Commissioner, supra). In light of the analogous legislative history of Sections 165(c)(2) and 212, any difference in treatment based upon difference in the language of the statutes involved seems somewhat dubious, yet this appears to be the basis for the distinction, which evidently originated with the Tax Court's decision in the Robinson case, supra. Since the purpose of both provisions is essentially the same with respect to the deductions they grant, namely, only to remove the "trade or business" requirement, it would seem that where expenses are deductible as production-of-income expenses, transaction-for-profit losses would also be deductible. See the Grammer case, supra, where the Tax Court implicitly suggests that it was looking more to the evidence indicating that the so-called offer to rent was not really binding on the potential landlord-taxpayer rather than to the requirement of actual rental, in denying the claimed loss deduction.

7/ (continued)
property's adjusted basis, was recognized as capital gain. Section 112(a) of the 1939 Code; see Sections 1001 and 1002 of the 1954 Code. The hardship resulting from the imposition of the tax on that gain was accentuated when the change in residences occurred because of the increase in the size of the taxpayer's family or a change in the taxpayer's employment location, and these cases became particularl numerous during periods of mobilization or reconversion. See H. Rep. No. 586, 82d Cong., 1st Sess., p. 27 (1951-2 Cum. Bull. 357, 377); S. Rep. No. 781, 82d Cong., 1st Sess., pp. 34-35 (1951-2 Cum. Bull. 458, 482). Accordingly, in 1951, Section 112(n) was added to the 1939 Code by Section 318(a), Revenue Act of 1951, c. 521, 65 Stat. 452. Section 112(n) was the predecessor of Section 1034 of the 1954 Code.

Section 1034, then, provides for non-recognition of gain on the sale of a residence only if the property is not held for the production of income. To hold that when a former residence is offered for sale it is, thereby, held for the production of income would be to read Section 1034 out of the Code.[8/]

That Congress understood that the sale of an old residence and the purchase of a new residence is usually a personal transaction, is also evident from the concern that Congress expressed for taxpayers who might feel compelled, under certain circumstances, to rent out either their old or new residences temporarily in the course of the sale and purchase. The Committee Reports state that (H. Rep. No. 586, supra, p. 109 (1951-2 Cum. Bull., p. 436); S. Rep. No. 781, Part 2, supra, p. 32 (1951-2 Cum. Bull., p. 566)):

> The term "residence" is used in contradistinction to property * * * held for the production of income. Nevertheless, the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in the light of all of the facts and circumstances in the case, prevent the gain from being not recognized. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he rents out the new residence during the period before he vacates the old residence will not prevent the application of this subsection.

8/ Of course, in the instant case, the sale of the old residence probably would not qualify under Section 1034 (had it been sold at a gain) in any event because the new residence was acquired not later than 1961 and the old residence, unoccupied for more than two years, was not sold until 1964, beyond the time limitations of Section 1034. See Stiegler v. Commissioner, decided March 6, 1964 (P-H Memo T.C., par. 64,057); Stolk v. Commissioner, 40 T.C. 345, 346-349, 350-356 (1963), affirmed per curiam, 326 F. 2d 760 (C. A. 2d, 1964); see generally, United States v. Sheahan, 323 F. 2d 383 (C. A. 5th, 1963).

See also H. Rep. No. 586, supra, p. 28 (1951-2 Cum. Bull., p. 377); S. Rep. No. 781, 82d Cong., 1st Sess., p. 28 (1951-2 Cum. Bull. 458, 483). Treasury Regulations on Income Tax (1954 Code), Section 1.1034-1(c)(3)(i). Clearly, Congress did not regard even the temporary rental of an old residence as a conversion of the property to the production of income under Section 1034, so long as rental was merely incidental to the personal sale and purchase of the residences involved.[9] The absence of any comparable cautionary statement for the mere temporary holding of an old residence for sale is explained by the obvious reason that Congress believed such a holding was so clearly personal in nature as to not warrant special comment.

So far, we have shown that the fact that the taxpayers offered their house for sale does not alone convert it from a personal asset to property held for the production of income. The other relevant factor in this case--the move of the taxpayers from their old residence to their new residence while they continued to offer their old residence for sale--also does not cause a conversion of the property to an investment asset in the circumstances of this case, for the taxpayers vacated their old residence not as a step in holding the house for sale as an investment but, rather, in connection with a change in residence, an entirely personal transaction.

9/ Where the property is thus temporarily rented out, presumably it would be considered to have been converted to the production of income but only for purposes of Sections 167(a)(2) and 212(2) to allow the deduction of depreciation and maintenance expenses so as to reduce the gross rental income received by the expenses incurred to earn it.

Like ordinary homeowners, these taxpayers were residing in their house when they first offered it for sale in the early spring or summer of 1961. They continued to make efforts to sell the property until it was finally sold in the spring of 1964. (R. 23.) But because their new residence, which they had built for them, was ready for occupancy in December of 1961, the taxpayers then moved out of their old house and into their new house. (R. 22.) Obviously, the taxpayers were quite prepared to sell their old house while they still resided in it. That they were unsuccessful in selling their house before their new house was ready for occupancy does not make the transaction any less personal than if they had been successful. During the time the taxpayers were trying to sell their house, the real estate market was declining. In 1961, the taxpayers' cost basis of their property was in excess of $80,000. The fair market value of the house declined from $80,000 in 1961, to $62,500 in 1964. (R. 21, 23.) The taxpayers were moving to a new residence and simply wished (R. 23) "to get their money out of" their former residence just as other taxpayers, desirous of disposing of other personal assets--pleasure boats, automobiles, home appliances--hope to recover at least a portion of their investment in such property. See *Ritter* v. *Commissioner*, decided October 9, 1946 (P-H Memo T.C., par. 46,237, pp. 807, 809-810), affirmed *per curiam*, 163 F. 2d 1019 (C. A. 6th, 1947).

As we have shown, the facts surrounding the taxpayers' move from their old house and their continued attempt to sell it are thoroughly consistent with the usual personal transaction of selling one's home. Furthermore, other facts are inconsistent with a conversion

of the house to an investment asset. After the taxpayers vacated their old house, they did not offer it for rent. Indeed, they agreed that "retention of the property for investment purposes was not justified." (R. 23.) If their intention was to hold it for sale as a profitable investment, they could have been expected to make the property desirable to prospective purchasers by fixing it up and keeping it in an attractive well-maintained state. But these taxpayers did just the contrary. When they moved to their new residence, they stripped the old residence, removing some of the permanent floor covering and (R. 23) "a truckload of plants and flowers." The taxpayers agreed that a tenant, and presumably a purchaser, would have (R. 23) "to make necessary expenditures to make the house habitable."

In our view, the facts in this case present a picture of ordinary homeowners who, due to personal reasons, moved into their new home before they had been able to sell their old house. When a homeowner moves from one residence to another, he hopes to be able to time his sale and purchase simultaneously. But, as this case shows, circumstances may not permit the timing to be quite so precise. But that is no reason, we submit, why the tax treatment of taxpayer A (who moves out of his old house, even though it has not been sold, because his new house is ready) should differ from the tax treatment of taxpayer B (who sells his old house but retains possession until his new house is ready) or taxpayer C (who sells and moves out of his old house before his new house is ready). In

each case, the circumstances in which the taxpayers find themselves are due simply to the vagaries of the personal activity of changing personal residences.

II

NO DEPRECIATION DEDUCTIONS ARE ALLOWABLE ON PROPERTY WHICH IS HELD SOLELY FOR SALE RATHER THAN HELD FOR AN ACTIVE USE SUBJECTING IT TO EXHAUSTION, WEAR AND TEAR WITHIN THE MEANING OF SECTION 167(a)

Even if this Court should disagree with our major contention and hold that taxpayers held their house for sale as an investment activity rather than as a personal activity, it is our position that depreciation deductions on that house would still not be allowable. Whether the depreciation issue in this case is approached from the standpoint of statutory language, legislative purpose, concept, or function, the result is the same--depreciation deductions are not allowable on assets held solely for sale.

Section 167(a) allows "as a depreciation deduction a reasonable allowance" only "for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property which is used in a trade or business or "(2) of property held for the production of income." As we have shown earlier, Congress enacted the predecessor to Section 167(a)(2) to end the discrimination against taxpayers whose profit-making activities did not rise to the level of a trade or business, and thus to allow depreciation on investment property to the same extent it would be allowed on trade or business property. The Committee Reports state that (H. Rep. No. 2333, _supra_, p. 78)

(1942-2 Cum. Bull. 430); S. Rep. No. 1631, supra, p. 88 (1942-2 Cum. Bull. 571)):

> Subsection (c) [Subsection (d) in the House Report] of this section amends section 23 (1) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

In a business context, it is clear that depreciation may be taken only on property which is actively used or on property which is being held ready for active use and may not be taken on tangible business property which is held only for sale. Treasury Regulations on Income Tax, Sections 1.167(a)-2 and 1.167(a)-10(b), Appendix, infra; Nulex, Inc. v. Commissioner, 30 T.C. 769 (1958); House v. Commissioner, decided March 9, 1959 (P-H Memo T.C., par. 59,047); Hillcone Steamship Co. v. Commissioner, decided August 21, 1963 (P-H Memo T.C., par. 63,220, p. 1262); New York City Omnibus Corp. v. Commissioner, decided November 30, 1948 (P-H Memo T.C., par. 48,254, p. 815); St. Louis Malleable Casting Co. v. Commissioner, 9 B.T.A. 110, 120 (1927); Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 754-755 (1954), affirmed on another issue, 230 F. 2d 555 (C. A. 5th, 1956); Duval Motor Co. v. Commissioner, 264 F. 2d 548 (C. A. 5th, 1959); see Sears Oil Co. v. Commissioner, 359 F. 2d 191, 198 (C. A. 2d, 1966). But cf. Mitchell v. Commissioner, 47

T.C. 120 (1966); Newberry v. Commissioner, decided February 27, 1945 (P-H Memo T.C., par. 45,077); Fagan v. Commissioner, decided January 26, 1950 (P-H Memo T.C., par. 50,017).

In any investment context, we submit, the rule is the same--depreciation can be taken only on property which is actively used in an investment activity. The legislative history cited above states that depreciation on investment property "is subject to the same limitations and restrictions" which are applicable to business property. As the above case shows, just as all business property is not subject to depreciation deductions, so all investment property is not depreciable; just as a taxpayer who is in the trade or business of renting trucks cannot depreciate a truck which he takes out of business use and holds only for sale, so an investor may not depreciate property which is not used for investment purposes but which is merely held for sale.

The function of depreciation is fundamentally inconsistent with allowing an investor to depreciate property held solely for sale. A depreciation deduction is designed to allow a taxpayer who is engaged in an income-producing activity (whether business or investment) to pay tax only on his net income which, in this context, would be net receipts from his income-producing activity less the decline in value of the assets that produce the income. See Massey Motors v. United States, 364 U.S. 92, 96 (1960); Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943); United States v. Ludey, 274 U.S. 295, 300-301 (1927); Burnet v. Harmel, 287 U.S. 103, 111-112 (1932). Where an asset is held not for use to produce income

in the current period but is held merely for eventual sale, any decline in value of that asset should not be reflected in the current period, through depreciation deductions, because it is reflected instead when the asset is sold, through a decreased sales price. In other words, when an asset is held only for ultimate sale, gain or loss will be incurred only upon final disposition rather than during the interim period. Hence depreciation, which reflects reduction or loss of value during the interim income-producing period, is not applicable.

The structure of the depreciation deduction section is inconsistent with allowing an investor to depreciate property held solely for sale. The Regulations to Section 167 provide that a depreciation allowance (Treasury Regulations on Income Tax (1954 Code), Section 1.167(a)-1(a)--

> * * * is that amount which should be set aside for the taxable year in accordance with a * * * plan * * * so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property * * *.

See also Section 1.167(g)-1 of the Treasury Regulations on Income Tax (1954 Code). How does one go about determining the "estimated useful life" of an asset held only for sale? It is well established that the useful life of the property to a taxpayer in his business or investment activity and the salvage value at the end of that period are to be used in computing depreciation. Massey Motors v. United States, 364 U.S. 92 (1960); see also Fribourg Nav. Co. v.

Commissioner, 383 U.S. 272 (1966). Here, it would be difficult, indeed, to determine the useful life of the property while held for the taxpayers, allegedly, for investment purposes, for that would require an estimation of how long it would take them to sell the property, and they might have sold it within a few weeks instead of holding it for more than two years.

Assuming that such a useful life could be estimated, comparable difficulties arise in attempting to determine salvage value at the end of the selling period. The Regulations provide that (Treasury Regulations on Income Tax (1954 Code), Sec. 1.167(a)-1(c)):

> Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. (Emphasis supplied.)

Because salvage value, which must be eliminated from the depreciation base of an asset, is defined as an estimate of "the amount * * * realizable upon sale", the typical investment asset which is acquired and held only for appreciation realizable upon sale will have no depreciation base. The sales price or "salvage value" will be estimated to be in excess of the cost (or other basis) of the asset, making a depreciation computation impossible.

The computation used for the asset in this case shows the impropriety of allowing depreciation on an asset held solely for sale. Contrary to the decided cases, the useful life of the asset was not based on an estimate of the period for which the taxpayers

intended to hold and use the asset--the period of time which they estimated would take to sell the asset--but was based on the physical life of the asset itself, 25 years. And the salvage value--an estimate of the amount realizable upon sale--was determined to be zero, even though to no one's surprise the taxpayers sold the property for $62,500. (R. 18-19, 24.)[10]

We recognize that the Tax Court decisions in Mitchell v. Commissioner, Fagan v. Commissioner, and Newberry v. Commissioner, all supra, are in conflict with our position here respecting the depreciation deduction. Cf. Robinson v. Commissioner, supra. Those decisions, we submit, are in error insofar as they held that a depreciation deduction may be taken for tangible properties held only for sale and not for some type of active use by the taxpayer for the production of income subjecting them to "exhaustion, wear and tear." It is evident from the opinions in the Mitchell and Newberry cases, supra, that in those cases the Tax Court erroneously looked to the portions of the 1942 Committee Reports dealing with the definition of income for the purposes of the Section 212 expense deduction to decide that depreciation deductions were allowable under Section 167(a)(2) or its predecessor provision. In those cases, the court overlooked the portion of the Committee Reports quoted, supra, specifically dealing with the depreciation deduction allowed by the predecessor of

10/It is beyond dispute that a stipulation, based on a mistake of law or ultimate fact is not binding on either party. See Commissioner v. Cummings, 77 F. 2d 670, 672 (C. A. 5th, 1935); Seatree v. Commissioner, 25 B.T.A. 396, 401 (1932), affirmed, 72 F. 2d 67 (C. A. D. C., 1934); Commissioner v. Ehrhart, 82 F. 2d 338, 339 (C. A. 5th, 1936); John A. Nelson Co. v. Commissioner, 75 F. 2d 696, 697-698 (C. A. 7th, 1935),
(continued)

Section 167(a)(2), which makes it abundantly clear that that provision grants a deduction only in those instances where business property comparably situated would be depreciable. That is not the situation in the instant case. 11/

CONCLUSION

For the reasons stated above in Part I, the decision of the Tax Court is erroneous in all respects and should be reversed. In the alternative, for the reasons stated in Part II, the decision of the Tax Court is erroneous insofar as it allowed a depreciation deduction and that part of its decision should be reversed.

Respectfully submitted,

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10/(continued)
affirming 28 B.T.A. 529 (1933), reversed on aother issue, 296 U.S. 374 (1935); Ohio Clover Leaf Dairy Co. v. Commissioner, 8 B.T.A. 1249, 1256 (1927), affirmed per curiam, 34 F. 2d 1022 (C. A. 6th, 1929), certiorari denied, 280 U.S. 588 (1929); McClintock-Trunkey Co. v. Commissioner, 19 T.C. 297, 304 (1952), reversed on another issue, 217 F. 2d 329 (C. A. 9th, 1954).

11/ While the Commissioner acquiesced in the decision in Mitchell (1967-1 Cum. Bull. 2), we have been advised that he is reconsidering that acquiescence, insofar as that case held that property held only for sale is depreciable.

It should be noted that the dictum in May v. Commissioner, 299 F. 2d 725, 727-728 (C. A. 4th, 1962) that certain types of property may be depreciable, even though held only for sale and not in any way being actively used, is based only on the decisions in Fagan and Newberry, supra. Moreover, the dictum in May was not in any way necessary

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of February, 1968.

____

Attorney

11/ (continued)
to the holding in that case. In May, the Court of Appeals held that a pleasure yacht abandoned for personal use and held for sale was not depreciable under Section 167(a)(2). We suggest that that holding is equally applicable to the facts in the instant case.

APPENDIX

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) General Rule.--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

(1) of property used in the trade or business, or

(2) of property held for the production of income.

*   *   *

(26 U.S.C., 1964 ed., Sec. 167.)

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

(26 U.S.C., 1964 ed., Sec. 212.)

SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

(26 U.S.C., 1964 ed., Sec. 262.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.167(a)-1 Depreciation in general.

(a) Reasonable allowance. Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) Useful life. For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probably future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experence in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reasor of conditions known to exist at the end of the taxable year ar shall be redetermined when necessary regardless of the method

of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167 (d) and § 1.167 (d)-1.

(c) Salvage. (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. * * *

*   *   *

(26 C.F.R., Sec. 1.167(a)-1.)

§ 1.167(a)-10 <u>When depreciation deduction is allowable</u>.

*   *   *

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. * * *

(26 C.F.R., Sec. 1.167(a)-10.)

§ 1.167(g)-1. <u>Basis for depreciation</u>.

The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

(26 C.F.R., Sec. 1.167(g)-1.)

§ 1.212-1 <u>Nontrade or nonbusiness expenses</u>.

*   *   *

(h) Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

*   *   *

(26 C.F.R., Sec. 1.212-1.)